Life Insurance in Its Relation to Thrift

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The Purpose of Life Insurance

The fundamental purpose of life insurance is the capitalization of the value of a human life, and through this means the protection of dependents or business interests against the loss of the value of that life through premature death.[1] But while this is its primary object, life insurance also accomplishes a very important secondary purpose, viz., the promotion and protection of thrift. No other business institution bears so many important relations to saving. At least four of these relationships deserve special mention, and as regards most of them life insurance is unique in its service and unapproached by any competitor.

1. Life Insurance Protects the Saving Period

A common objection against life insurance may be stated as follows: "I do not believe in life insurance, I believe in saving, and I can make and save more in other ways." The answer to this objection is that life insurance alone makes saving feasible for the great majority of people. If possible, both insurance and saving in other ways should be practiced. But to start on a plan of saving (outside of life insurance), where a dependent family exists, without hedging against the

[1] Emphasis should be placed upon the value of human life as contrasted with the value of mere property. The productive lives in any community constitute by far its greatest economic value. It is the purpose of life insurance to capitalize this value for the benefit of the insured's family or business. For years we have developed a science, "corporation finance," which deals with the capitalization of lands, buildings, equipment, and good will. But it is only in recent years that our thoughts have turned to the incorporation of human life values, and life insurance furnishes the only known method of capitalizing the producing value of a life. The analogy between life insurance and corporation finance is complete. Life insurance is corporation finance applied to human values. From the moment the policy is issued an estate has been created. A life insurance policy is a *callable sinking fund* bond issued upon the life of the policy holder. It will be paid if Providence calls the policy holder. In case there should not be a call, the bond will also be paid through the accumulation of its *sinking fund* provision, or the *reserve* as it is commonly called. Live or die, payment of the bond is a certainty. The value of the earning capacity of the life has been capitalized, and should premature death destroy this value the proceeds of the life insurance policy will act as a substitute to continue, in a measure at least, the former earning capacity of the deceased.

The *protective* feature of life insurance, and for that matter of all forms of insurance, has received too little emphasis from economists. Their efforts have been confined mainly to a discussion of the problems connected with production, distribution and consumption, and a review of leading text-books on economics indicates the authors' difficulty in assigning insurance to some one of the standard divisions of the science. Often the subject is treated merely in an appended chapter. Insurance cannot logically be placed in any of the aforementioned categories. It partakes somewhat of all, it is true, but its real place is in a separate division of economic science, viz., the *elimination of risk*. The real function of all insurance is the *elimination of risk* in our economic activities. It is to be hoped that our text-books on economics will soon assign to insurance the separate division that its distinct function in our economic life so well warrants. Elimination of risk, as here suggested, contemplates not only the many commercial forms of personal and property

uncertainty of having the saving period cut short by an untimely death, is for the overwhelming majority of people an act of wanton foolishness and gambling.

It is easy to make a resolution to save $10,000 in 20 years by ways other than life insurance. But let us not forget that we are only human beings and that the fulfillment of a resolution is on the average a very doubtful product of a somewhat frail and exaggerated mentality. Assuming the sincerity of the resolution, there are three great obstacles that should always be borne in mind. In the first place, what right has a man with dependents to say, "I will save $10,000 in 20 years," when he does not know that that number of years—yes, even one year—will be given to him. The mortality table shows that out of 85,441 persons 30 years of age, 720 will be cut short in their effort to save the above $10,000, in the first year of the trial; and in all 15,637 will fail to accomplish their purpose in the set time of 20 years through premature death.

But death is not the only factor that may defeat the carrying out of a resolution to save. Let us not forget that a resolution to save, even eliminating the chance of premature death, is confronted by two other great dangers: (1) lack of will power to continue the plan (the resolution being more often ended in this way than by death) and (2) failure to keep intact what may have been saved, owing to bad investment, speculation, or tempting expenditures. Let us not forget that only about one adult in ten manages to accumulate a fairly decent competency, and that one half of the limited number who succeed in doing so again lose the same before death.

The three pitfalls just mentioned may be easily avoided through the use of life insurance which assures an estate—live or die—equal to the full face value of the $10,000 promise, as soon as the first premium is paid. In other words life insurance insures the resolution to save the $10,000 in 20 years. An illustration of a 20-year $10,000 endowment policy will serve to make this clear. Such a policy promises $10,000 at any time in the event of death during the 20-year period, and also the payment of the same sum at the end of the 20-year period in the event of survival, i.e., $10,000 is promised, live or die. An analysis of this contract shows that it is composed of two distinct portions, each supplementing the other. One portion represents a savings bank accumulation which is available at any time (after the second or third premium is paid) to the insured through surrender of the policy or at the maturity of the contract. But this savings feature is supplemented by term insurance (the other portion) which is, however, not a level term insurance of $10,000 at any time, but an insurance of an amount, which added to the investment accumulated in the savings fund at the time of death will make the amount of the policy payable equal $10,000. The term insurance portion of the contract is for a decreasing amount, being nearly equal to the full face value of the policy at the start, and gradually decreasing throughout the term of the contract. Thus, if at a particular time

insurance, but also the numerous other economic devices which accomplish the same economic function, such as "continuous organized markets," "hedging" in our produce and security markets, "options," "future contracts," "short selling," "stop loss orders," etc.

the savings portion of the endowment policy has accumulated to $1,000, the insured will be protected by $9,000 of term insurance. In the event of death, the insurance company will pay the saving accumulation of $1,000 plus the term insurance of $9,000, or a total of $10,000. In other words the insurance company agrees always to make good the difference between the amount actually saved (in this case $1,000) and the originally proposed estate which the insured was not given time to save (in this case $10,000), or $9,000. Had the insured relied upon other methods of saving, he would have left a pittance of $1,000, a sum totally out of accord with duty and good citizenship where a dependent family is at stake. When the accumulation under our policy reaches $5,000 there will be term insurance for only $5,000. Finally, at the end of the 20-year period, the savings fund will have grown to the full face value of the policy of $10,000, and the term insurance protection will have been reduced to zero. The original resolution having been fulfilled, the insurance protection necessary to protect the saving period is now no longer needed; and the insurance company will pay the full sum, or continue to hold the same in trust at the option of the insured.

The premium for the policy may be divided into two distinct parts, one part for the savings or investment fund, and the other for the decreasing term insurance. It should here be noted that all life policies, other than mere term contracts, are endowment policies. The 20-year endowment policy, for example, accumulates a savings fund which will equal the face value of the policy at the end of 20 years, the same then being paid to the insured. A whole life policy, on the other hand, is also an endowment policy maturing at age 96, i.e., the savings fund in a whole life policy gradually accumulates to the full face value of the policy at the end of life, which is 96 according to the American experience table. At that time the policy will be paid although actual death may not have occurred. In a long term endowment policy, at any given age, the savings fund is so arranged as to accumulate gradually to the full face value of the policy at say, age 65, the age of retirement, or as it might more properly be called, the age at which economic death occurs.

Protection of the saving period is the most important relationship of life insurance to saving. In our illustration, life insurance was used for a two-fold purpose, viz., to save as well as to protect the saving period. But even where the saving is effected outside of life insurance it is highly essential to use some kind of a life insurance policy to protect the saving period, although it be only a pure term insurance policy. Every building and loan association account should be hedged; otherwise great distress may result in case an untimely death cuts short the saving account to a mere pittance. Every mortgage on a home or a small business should likewise be hedged with life insurance. Briefly stated the insurance proceeds, in the event of death, serve to complete the building and loan association account or the payment of the mortgage. Moreover where earnings are reinvested in a business enterprise, especially during the early years of development, or where the business is of a speculative nature, such investment should be protected against loss through the capitalization of the value of the life that constitutes the backbone of the business venture.

2. Life Insurance Is Saving

The above illustration should make it clear that life insurance policies, other than ordinary term policies, contain an important savings feature. At the close of 1917 such savings held in trust for policy holders by 241 American life insurance companies aggregated $6,000,000,000, and the gain in the savings for the year exceeded $400,000,000, or at the rate of $141,801 for every working hour of the year (assuming an eight hour day), $2,364 every working minute and $39 every working second. This showing has been greatly exceeded since 1917, although exact figures are not yet available. As a matter of fact, life insurance is distancing all other savings institutions. The savings accumulations of the 241 regular life insurance companies at the close of 1917 were three and one third times the combined assets of the 7,269 building and loan associations in the United States as reported to the annual meeting of the United States League of Local Building and Loan Associations. The gain in the savings of these insurance companies during 1917 amounted to nearly three times the total gain in assets for all the building and loan associations of the country. Moreover, the savings for policy holders held by these insurance companies exceeded the total deposits of all the 1,807 savings banks of the country by $467,000,000. The gain in the savings of the companies during 1917 amounted to nearly one and one third times the total gain in the deposits of all the savings banks in the country.

All these immense savings are earning a very fair rate of interest considering the safety of the investment. Past experience shows that life insurance companies have earned on the savings held for policy holders the largest interest return consistent with safety. During 1917 the interest earned on all the mean invested funds of the 38 leading companies was 4.94 per cent; while the average annual interest return for 20 years (1898–1917) was 4.80 per cent.

Not only is the rate of earnings very substantial, but, judging from the solvency record of insurance companies, the security of the savings held is the very best. Very rarely is there a failure of a life insurance company after it has once passed through the stage of initial development. Even in the case of newly formed companies, the insolvency record shows an inconsequential loss of savings. This may be illustrated by the record for the decade 1905–14, a wholly abnormal period in life insurance history which was characterized, as probably never before, by a craze for forming new companies. During that decade 55 companies suspended operations, but all died during infancy, the average age of these companies being four years. The combined insurance of all the failing companies was only $139,500,000,[2] and of this all except $1,033,000 was reinsured in other companies. In other words only one dollar out of every $140 of protection carried by the suspending companies was lost; but even here the policy holders had returned to them the full cash value (the savings) of their policies. The reasons for such stability are not difficult to comprehend. In the first place, life insurance "is based on nature's law of mortality." A sinking fund is accumulated in advance for all

[2] The combined insurance carried by all the regular companies exceeded $27,000,000,000 at the close of 1917.

future payments as per the requirements of a conservative mortality table, and the acceptance of risks is based on a medical selection. Moreover, no other business is so stringently regulated and supervised by the state. A drastic record of solvency is required by law, and investments, commissions, expenses, and important practices are dictated by statute. The investments of the companies are also so widely scattered as to kind, class, and location that a possible loss in one investment is counter-balanced by a gain in other directions.

3. LIFE INSURANCE REPRESENTS COMPULSORY AND CONVENIENT SAVING

The regular payment of the premium from year to year will soon be looked upon by the insured in much the same manner as he comes to regard interest upon a mortgage. Consequently, to secure the necessary funds to pay the premium, his industry will be considerably enhanced, or his efforts to save the required premiums out of income will be increased. It is the common assertion of individuals who hold life insurance policies that they became the possessors of a considerable sum of money which, under other circumstances, they would never have accumulated, or which, if they had done so, would have been lost or dissipated. Life insurance causes policy holders to stick more steadfastly to their resolution to save than do other agencies for the inculcation of thrift. When once started, the desire to remain protected through insurance acts as a powerful spur to continue the savings feature. The regular payment of premiums soon strengthens the policy holder's ability to save and soon moulds his thought in the right way. Not only is the saving habit developed through life insurance, but the insured's effort to acquire the where-with-all is also increased. When the necessity of insurance protection is once recognized, household and personal expenses are soon adjusted to the necessity of paying the premiums.

Saving under life insurance policies is also convenient, the method being admirably adapted to the placing of small sums to prompt and profitable use. The premiums may be paid in installments, if desired, and every dollar deposited with the company begins immediately to earn interest. It is for this reason that life insurance has been called "compound interest in harness." The average investor cannot invest his small savings as regularly as can the insurance company. For the average person a life insurance policy represents the accumulation of small sums (which in all probability would not otherwise be accumulated) over a long period of years into a substantial total. Stated in another way, life insurance bears the relationship to thrift that the modern utilization of by-products (largely wasted in former years) bears to many of our leading manufacturing enterprises today. The periodic driblets—the premiums—are not particularly missed by the insured. In fact they were earned—and otherwise would probably not have been—in anticipation of the due date of the premium; and had they been otherwise earned it may be doubted whether they would have been saved; and had they been saved it may be doubted whether they would have earned a fairer rate of interest elsewhere. The present savings held in trust for policy holders by the regular companies aggregate some $6,000,000,000. It is doubtful whether one fifth of this huge sum of capital would be in existence today if it had not been for the com-

pulsory and systematic influence upon saving exerted by the life insurance method.

4. Life Insurance Protects Against the Hazard of Outliving One's Income

Assuming the efficiency of the protective and compulsory savings features of life insurance, the thinking public is rapidly coming to recognize the desirability of conserving the principal of a life insurance policy against the modern tendencies of reckless expenditure or loss through speculation or unfortunate investment. To assure an income for life, it is now common to issue policies on the "income plan." This means that the principal of the insurance, instead of being given to the beneficiary in a lump sum, will be paid in installments for a definite number of years, like 20 years, irrespective of whether the beneficiary lives that long or not, and for as many years thereafter as the beneficiary may survive. In this way a definite income is assured as long as it may be needed by the beneficiary, i.e., for life. The insurance company becomes the trustee of the principal of the policy. Judged by a mortality table the average life of beneficiaries, at any given age, is well known. Therefore, the beneficiary may be promised an annual or monthly income for life, and the amount promised will be derived from two sources, viz., (1) a portion of the principal itself, and (2) the interest earned on the balance of the principal remaining with the company after the payment of each installment.

The same function is performed by annuities, which may be defined as contracts, whereby for a cash payment the insurance company agrees to pay the annuitant a definite income for life. Their purpose is to protect against the hazard of outliving one's income, and at the same time to increase the income to an extent which contemplates the gradual exhaustion of the principal itself.

To illustrate the manner in which annuities permit the utilization of savings for old-age support, let us assume that a man aged 65 possesses $15,000, and that this fund constitutes his sole means of support. If invested in the most careful manner, let us say in "gilt-edged bonds," so as to avoid any danger of loss, the current rate of return will not exceed 5 per cent, thus limiting the owner's income to $750 a year. This amount may prove woefully inadequate for proper support, yet the owner, not knowing how long he may live, does not feel that he can afford to take a portion of his principal each year for living expenses, because impairment of the principal means a corresponding reduction in income. The danger confronting this man is just the opposite of that facing the man who wants insurance against death. The latter wants insurance because he does not know how long he may live, while the former wants assurance that he will not outlive his income.

The difficulty referred to can be remedied by investing the savings fund of $15,000 in a life annuity. By doing this a definite and much larger income, guaranteed for the whole of life, can be obtained. To quote the rates of a certain company, the investment of the $15,000 in an annuity at age 65 will yield an annual income throughout life of $1,538.10, instead of $750 per annum, or $10\frac{1}{4}$ per cent as compared with the current rate of 5 per cent. As the age of the annuitant when purchasing the annuity increases, the

greater will be the return, amounting in this company to nearly $12\frac{1}{2}$ per cent at age 70 and to nearly $15\frac{1}{2}$ per cent at age 75. These large returns are possible (1) because the death rate following ages 65, 70, and 75 is very high, and (2) because in accordance with the meaning of an annuity all payments will cease upon death and the unused portion of the purchase price of the annuity will redound to the benefit of those annuitants still living. The apparently large return is again made up of two portions, viz., (1) a part of the principal, and (2) interest earnings on any net balance held by the company.

The advantageous use of annuities by many classes of people must be apparent. Even where a decent savings fund has been accumulated, it is usually of such modest size that the enjoyment of the fruits of a life's toil for the period of retirement from active life is spoiled by the economy that must be exercised to make ends meet, by the limited character of the comforts that can be obtained with the fund available in view of the high cost of living, if the principal is not to be touched, and by the prospect of losing the source of the income itself through unfortunate investment. The prospect, amounting almost to a terror, of living too long, makes necessary the keeping of the entire principal intact to the very end, so that as a final wind-up, the savings of a lifetime, which the owner does not dare to enjoy, will pass as an inheritance to others. In view of these facts it is surprising that so few have undertaken to enjoy *without fear* the fruits of the limited competency they have succeeded in accumulating. This can only be done through annuities. Why exist on \$750 a year (assuming 5 per cent on \$15,000) and then *live in fear* when \$1,500 may be obtained at age 65 through an annuity *for all of life* and *minus all the fear?*